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OIL AND GAS SECURITY INTERESTS IN THE 1990s: A NEED FOR CONSISTENCY AND UNIFORMITY

ALVIN C. HARRELL*

Introduction

Oil and gas financing in the 1980s reflected the energy boom-bust cycle of that decade. An explosion of energy-related financing during the oil boom times of the early 1980s was followed by a harsh reaction which made it very difficult to obtain credit for oil and gas purposes in the latter half of the decade.¹ As we enter the decade of the 1990s, problems in the banking system and the continuing volatility of energy prices continue to present challenges to those seeking to finance the development of domestic energy resources. In addition, however, uncertainties, inconsistencies, and nonuniformity in the laws governing oil and gas financing are creating unnecessary impediments for both producers and lenders. This article will discuss some of these legal impediments, comment on historic trends, and offer suggestions for possible reforms.

Basic Problem Areas — An Overview²

In energy lending transactions there is often an inherent tension between the real property concepts familiar to energy law practitioners and basic Uniform Commercial Code (U.C.C. or the Code) concepts. Oil and gas

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1. See generally M. SINGER, *FUNNY MONEY* (1985); P. ZWEIG, *BELLY UP* (1985); B. CLARK, *THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE* 13-1 to 13-29 (2d ed. 1988) (chapter 13). References to "the U.C.C." or "the Code" are references to the Oklahoma U.C.C. unless otherwise noted.

In a previous article the author argued that this was an overreaction and that, with proper loan documentation, prudent oil and gas lending should be a safe investment despite volatile energy prices. See Harrell & Dancy, *Oil and Gas Financing Under Uniform Commercial Code Article 9*, 41 OKLA. L. REV. 53, 53-55 (1988) [hereinafter *Oil and Gas Financing*]. This article reviews and updates many of the basic issues discussed in that article. However, this article goes beyond the previous one to note specific problem areas and to suggest possible improvements in the law to address these concerns.

The author would like to acknowledge the assistance of Professor Fred H. Miller, James R. Ryan, and Tony M. Davis in the preparation of this paper. The author is solely responsible for any errors and for the policy arguments advanced herein.

2. This portion of the paper is indebted to a letter from James R. Ryan, law firm of Conner & Winters, Tulsa, Oklahoma, to Alvin C. Harrell (July 3, 1990) [hereinafter Ryan letter]. The letter draws on Ryan's extensive experience in this area to describe the basic legal controversies in oil and gas financing.

practitioners may view themselves as real estate lawyers; they may feel that oil and gas financing is largely a matter of real property law and that U.C.C. concepts are an alien influence. In contrast, U.C.C. practitioners (who frequently represent the lenders asked to finance oil and gas transactions) often view severed oil and gas, and the equipment used to produce, transport, and store it, as personal property subject to the U.C.C.³

In general there is a need to reconcile these conflicting views in order to provide greater consistency and uniformity in this area of the law. Because oil and gas equipment, severed minerals, and related accounts and proceeds are personal property, it seems likely that this can best be achieved by complete integration of the applicable law into U.C.C. article 9 (which covers security interests in personal property). This would mean that oil and gas legal concepts derived from real property law would have to be reconciled with the competing provisions of article 9, possibly in a manner similar to the way article 9 treats fixtures.⁴ In contrast to this approach, however, in the past the tendency has been to favor real estate mortgage and conveyancing laws. At this point, from the standpoint of integration of oil and gas financing into article 9, there is something of an impasse. As James R. Ryan has noted:

In nearly all of the oil and gas states the real estate types have set the patterns [and the] U.C.C. drafters have compromised by requiring that financing statements perfecting security interests involving minerals to be financed at the wellhead contain a description of the land and be indexed in the real estate records.⁵

The result is that oil- and gas-related personal property collateral, to a large extent, is treated differently from other, similar types of personal property collateral under article 9, and is subject to considerable deference to real property law. Furthermore, because real property law varies from state to state, for multistate transactions there is considerable nonuniformity of applicable law in terms of the relationship between article 9 and real property law, in terms of the underlying real property law, and in terms of nonuniform amendments to article 9.⁶ These issues represent significant challenges

3. For an example of an effort to reconcile these kinds of tensions outside the scope of article 9, see 12A OKLA. STAT. § 2-107 (1981). *Cf. id.* § 9-105(1)(h) (article 9 definition of "goods"); *id.* § 9-402(5) (special perfection rules for certain oil- and gas-related collateral).

4. *See, e.g.,* 12A OKLA. STAT. § 9-102 (1981); 12A OKLA. STAT. § 9-313 (Supp. 1985). *See infra* note 6. It should be noted that this may not be the best approach because it would still leave oil- and gas-related personal property subject to different rules than for similar personal property used for other purposes. Probably the best approach, in terms of simplicity and consistency, would be to sever the links between real property law and oil- and gas-related personal property, and treat the latter just like any other type of personal property under article 9. However, this would also be the most radical approach and may not be politically feasible.

5. *See* Ryan letter, *supra* note 2.

6. *See, e.g., Oil and Gas Financing, supra* note 1, at 55-57, 82-83, 87-98. Many of the same basic issues are confronted in the context of fixtures collateral, which is likewise tied to real estate law (literally and figuratively) due to the inherent characteristics of the collateral

for the oil and gas lender and producer, and seem to be ripe for a statutory solution that would involve revision of U.C.C. article 9.

*The Nature of Oil- and Gas-Related Collateral:
Sources of Issues and Problems*

Once minerals are severed from the realty, they clearly become movable, tangible personal property and in practice are treated as goods by most parties who deal with them. However, because real property law may treat these minerals as "rents and profits" of real property, and because of the deference to real property law with regard to perfecting a security interest in minerals under Oklahoma's article 9, to a significant extent real property law may continue to apply to minerals after extraction.⁷ As a result, any

and by reason of 12A OKLA. STAT. § 9-313 (Supp. 1985). Indeed, in some ways fixtures are even more firmly related to real property because they are not normally removed from it, in contrast to oil and gas production. Some other differences should be noted, however, which impact any comparison of the U.C.C. treatment of fixtures with the treatment of oil and gas collateral.

As with some oil and gas collateral, many of the problems involving fixtures derive from the fact that fixtures are simultaneously subject to two parallel systems of law — real and personal property law. Section 9-313 provides a matrix of rules to resolve the resultant conflicts while maintaining consistency within article 9, a significant achievement that resulted from the attention given to this area of law as part of the 1972 revisions to the uniform text of the U.C.C. See, e.g., *Oil & Gas Financing*, *supra* note 1, at 85-87; *infra* notes 99-105 and accompanying text.

In contrast, the problems involving oil and gas collateral are more complex, involve greater U.C.C. deference to widely divergent state real property laws, and often are not subject to resolution under article 9 because there is no provision with a scope equivalent to § 9-313 for oil and gas transactions. (Oklahoma's § 9-402(5) is purely a perfection provision and does not resolve priority issues deriving from the interface between real and personal property law. 12A OKLA. STAT. § 9-402(5) (Supp. 1985)). Also, there are some fundamental differences between minerals and fixtures, and these differences limit the relevance of comparisons to § 9-313. For example, fixtures begin as goods and therefore may be subject to article 9 before real estate law becomes applicable. See 12A OKLA. STAT. § 9-105(1)(h) (1981) (defining "goods" as personal property movable at the time of attachment). In contrast, minerals arguably begin life as real property and only later become personalty. See *id.* (defining goods to exclude "minerals or the like, including oil and gas, before extraction").

It is possible for a realty interest to be the basis for a claim against extracted oil and gas under real estate law, after the minerals have become purely personal property by reason of the extraction, e.g. pursuant to an assignment of rents and profits clause in a real estate mortgage. See, e.g., 46 OKLA. STAT. § 4 (Supp. 1986). This is much less common in the law of fixtures (although it is possible for a real estate mortgage to be the basis for a claim against a fixture that has been removed from the realty). Unlike the rules on fixtures at U.C.C. § 9-313, there is no article 9 resolution of this problem in the context of oil and gas transactions.

These kinds of problems will be discussed *infra*, and, despite the limitations of an analogy to fixtures, the conclusions and recommendations will suggest solutions for oil and gas security interest problems that include the possible incorporation of a new article 9 section for oil and gas collateral, perhaps inspired by U.C.C. § 9-313. Still, the limitations of any solution based on § 9-313 need to be kept in mind throughout this analysis.

7. See *supra* note 6. As noted, for oil and gas security interest problems the article 9 term "goods" does not include minerals *before* extraction. 12A OKLA. STAT. § 9-105(1)(h)

party dealing with extracted minerals is confronted with a confusing matrix of interrelated rules requiring an analysis of real and personal property concepts under article 9, real estate mortgage law, and other state law. As noted, there is also widespread nonuniformity in the laws of different states which may create some unique choice of law problems.

Special problems also arise with regard to other types of oil- and gas-related collateral. For one thing, much oil- and gas-related collateral is single-use property that cannot be easily converted to alternative purposes. For example, drilling rigs and production equipment have no other practical use except possibly as scrap. Similarly, mineral interests and hydrocarbons in place have no value absent the potential for economic production. As a result, the value of such collateral is wholly dependent on the economic and legal feasibility of oil and gas production. Mineral interests have no value beyond the production life of the minerals. Production depletes the asset; the only question is how rapidly this will occur. There is no residual or renewable value once mineral production is exhausted. These considerations reflect the unique nature of much oil and gas collateral, and may justify special article 9 provisions dealing with perfection of a security interest in such collateral; any resulting inconsistencies within article 9 (as a result of similar types of goods being treated differently) may be explained by the need to reflect the specialized nature of oil- and gas-related property. On the other hand, the resulting complexities suggest a need to achieve the highest possible degree of consistency and uniformity within article 9.

Under current law, in many instances oil and gas collateral will be viewed as having attributes of both personal and real property, and in many instances the precise nature of the property interests involved is not clear.⁸ Thus, under current law, oil and gas transactions may trigger inherent conflicts between real property law and personal property law. There are U.C.C. provisions that deal with the relationship between real and personal property law in the context of oil and gas collateral, but for the most part these provisions do not address the priorities of competing interests and

(1981). However, the Code comment suggests that unsevered minerals could be treated as general intangibles. It is clear that article 9 treats severed minerals as "goods" subject to article 9. See, e.g., 12A OKLA. STAT. § 9-105 (1981); *Oil and Gas Financing*, *supra* note 1, at 56. Note, however, the special deference to real property law at 12A OKLA. STAT. § 9-402(5) (Supp. 1985). This nonuniform provision is discussed *infra* notes 24, 32-35 and accompanying text.

8. See, e.g., the description of the nature of mineral interests at 1A W. SUMMERS, OIL AND GAS § 152, at 371 (1954), *quoted in Oil and Gas Financing*, *supra* note 1, at 55-56:

[A] profit a prendre, a corporeal hereditament, an incorporeal hereditament, an estate in land, not an estate in land, an estate in oil and gas, a servitude, a chattel real, real estate, interest in land, not an interest in land, personal property, a freehold, a tenancy at will, property interest, and the relation of landlord and tenant.

It should be noted that this refers to interests in unextracted minerals and should not affect the treatment of extracted minerals as ordinary personal property.

other important issues.⁹ As a result, in many instances there is no clearly applicable law to resolve important issues.

Because of the nonuniformity among the states in this area of law, the general deference to real property law, and uncertainties or deficiencies in the common law regarding oil and gas, even the basic legal character of the collateral (and therefore the appropriate method of perfection) may differ from one state to another. Therefore, any multistate oil and gas lending transaction requires careful analysis of, and compliance with, the technical requirements of all states that have a connection with the transaction. This may require compliance with a wide and complex range of personal and real property laws in a number of different states, creating unnecessary multiplication of effort and uncertainties as to the applicable law. These issues will be discussed with more specificity in the context of each of the most common types of oil and gas collateral.

Oil and Gas Leases

An oil and gas lease represents a right to explore for and extract minerals, rather than an interest in real property. Despite this, an oil and gas lease is generally treated as real property collateral and therefore is generally not regarded as being subject to article 9. This is somewhat curious in view of the hybrid nature of the leasehold interest and its obvious personal property aspects but nonetheless appears to be the law.¹⁰

9. In the context of article 2, see 12A OKLA. STAT. § 2-107 (1981). There is no direct equivalent to govern security interests in oil and gas under article 9. Cf. 12A OKLA. STAT. §§ 9-105(1)(h), 9-402(5) (Supp. 1985). Section 2-107 provides a hierarchy of priorities for resolving conflicts between real and personal property law in the context of a sale of goods to be severed from real property, including oil and gas (as well as other minerals, timber, crops and even structures). In a sense, this does for sales what § 9-313 does for security interests in fixtures. *Id.* § 9-313. There is no equivalent in the uniform text of article 9, and the nonuniform Oklahoma amendment at § 9-402(5) generally defers to real property law for purposes of perfection, but otherwise fails to answer the questions that arise from the relationship between real and personal property law. *Id.* § 9-402(5). See *infra* notes 20, 26, 33, 38, 90-93.

10. See *Oil and Gas Financing*, *supra* note 1, at 57-68; *Ingram v. Ingram*, 521 P.2d 254 (Kan. 1974) (oil and gas lease is not personal property subject to article 9 because it is treated as real property for purposes of the recording acts). *Ingram* was largely a product of the court's conclusion that minerals in the ground should be treated as real estate. Once that decision is reached, the *Ingram* result is consistent with article 9. See OKLA. STAT. § 9-104(i) (Supp. 1989). However, that decision does not seem either necessary or inevitable. See U.C.C. § 9-105 comment 3 (1989).

Whether an oil and gas lease, or the interests it represents, should be treated as real or personal property is really a much more complex issue than *Ingram* and similar cases would suggest. The oil and gas lease is essentially a contractual right to search for and extract minerals. As such, it is not a traditional estate in real property. Indeed, in the typical case, the parties to the lease do not even know whether minerals exist. As in *Ingram*, judicial efforts to classify oil and gas leases generally have focused on a particular theory and have been made for a limited purpose. Professor Summers characterized these efforts as futile and "purely academic." See W. SUMMERS, *supra* note 8, at 379-80. "There seems to be no common-law name for such an interest and no useful or practical purpose is served by attempting to fit

There is a remote possibility that an oil and gas lease or similar contract could be considered "realty paper" (that is, a real estate version of "chattel paper" as defined at U.C.C. subsection 9-105(1)(b)), and therefore brought within the scope of article 9 by means of a creative analysis under subsections 9-102(3) and 9-104(j). While neither the statute nor the case law supports such an argument,¹¹ uncertainties relating to the nature of oil and gas leasehold estates suggest a possible need to address this issue with regard to specific oil and gas transactions and also in any revision of article 9.¹²

It is also possible that the contractual rights represented by an oil and gas lease could be treated as an "account" under U.C.C. section 9-106, on the theory that the lease represents a right to payment for minerals to be extracted and sold as goods. This view is supported, at least inferentially, by the treatment of such minerals as goods under U.C.C. section 2-107 (subject, however, to prior realty interests), by the definition of "goods" at U.C.C. subsection 9-105(h), and by the general recognition that an oil and gas lease represents only a right to extract and sell the minerals and not an interest in land or in minerals in the ground (or any other real

such interest into the common-law scheme of things." *Id.* at 382. *See also* Continental Supply Co. v. Marshall, 152 F.2d 300 (10th Cir. 1946) (oil and gas lease is a "chattel real," an "incorporeal hereditament," and a "profit a pendre," representing only a right to explore for and produce personal property).

Interestingly, the Oklahoma Title Examination Standards make it clear that an oil and gas leasehold estate is not real property for purposes of a judgment lien under title 12, § 706 of the Oklahoma Statutes: "[T]herefore, a money judgment filed in the office of the county clerk . . . does not create a lien" on a leasehold estate. 16 OKLA. STAT. ch. 1 appendix, Title Examination Standard 12.5 (1988) (citing First Nat'l Bank v. Dunlap, 254 P. 729 (Okla. 1927), and Hinds v. Phillips, 591 P.2d 697 (Okla. 1979)); *see also* *Oil and Gas Financing*, *supra* note 1, at 58 n.23.

11. Unlike chattel paper, there is no definition of "realty paper" in article 9, nor is there any hint of a recognition of any such concept in the U.C.C. *But see* *Oil and Gas Financing*, *supra* note 1, at 59-62 (citing Citicorp v. Fremont Nat'l Bank, 738 P.2d 29 (Colo. Ct. App. 1987) (real estate sales contract equitably converted to personalty in the nature of "realty paper"))).

12. *See, e.g.,* Rucker v. State Exch. Bank, 355 So. 2d 171 (Fla. Dist. Ct. App. 1978); Citicorp, 738 P.2d 29; Security Bank v. Chiapuzio, 304 Or. 438, 747 P.2d 335 (1987). Judge TeSelle has described the nature of a lease bonus, and the status of a real estate mortgagee's claim to a lease bonus, as follows:

Debtors' lease bonus was a cash payment by lessee for Debtors' execution of the lease. *Sykes v. Dillingham*, 318 P.2d 416, 419 (1957). A "lease bonus does not represent payment for any portion of the mineral produced, but is the consideration for the option to explore and remove minerals, granted by the lease." *In re Levy*, . . . 94 P.2d 537, 539 (1939). Bank's security interest extends only to the real property and the underlying minerals. Because the lease bonus is not considered payment for the minerals, Bank has no lien against the lease bonus.

Order Determining Extent of Stock Exchange Bank's Secured Claim, Granting in Part Debtors' Motion to Avoid Lien, and Sustaining in Part Objections to Exemptions at 7, *In re Hartley*, No. 89-2201-TS (Bankr. W.D. Okla. May 18, 1990). *But see* Continental Supply Co. v. Marshall, 152 F.2d 300 (10th Cir. 1946) (mortgage on an oil and gas lease must be recorded in the real estate records and is therefore to be regarded as a "real estate mortgage").

property).¹³ There is also a strong argument that an oil and gas lease should be treated as a “general intangible” under U.C.C. section 9-106. If an oil and gas lease is not an “account,” then almost certainly it should be treated as a general intangible for purposes of article 9. Unfortunately, for the most part the courts have not been of much help in this regard. Again, this is a point that should be clarified in any revision of article 9.

Royalty and Other Contractual Interests

Royalty, mineral, and overriding royalty interests represent rights to minerals in the ground and in Oklahoma generally are considered real property not subject to article 9.¹⁴

In contrast, production payment contracts represent a right to payment from the proceeds of mineral production. In this respect they resemble a

13. See, e.g., *Oil and Gas Financing*, *supra* note 1, at 58-59. This view is further bolstered by the traditional view that an oil and gas lease is not real property to which a judgment lien will attach. *Id.* See also *supra* notes 10-12.

14. See, e.g., *Peppers Ref. Co. v. Barkett*, 208 Okla. 367, 256 P.2d 443, 446 (1953) (minerals in the ground remain real property until extracted; a royalty interest “is a part of the mineral interest”). Cf. *Elliott v. Berry*, 206 Okla. 594, 245 P.2d 726, 729 (1952) (royalty interest is “an interest in the production”); *Colonial Royalties Co. v. Keener*, 266 P.2d 467 (Okla. 1953) (royalty owner is entitled to fractional share of minerals produced). These cases were cited and described by Judge TeSelle in his Order Determining Extent of Stock Exchange Bank’s Secured Claim, Granting in Part Debtors’ Motion to Avoid Lien, and Sustaining in Part Objections to Exemptions, *In re Hartley*, No. 89-2201-TS (Bankr. W.D. Okla. May 18, 1990). In that Order Judge TeSelle described the lien obtained by a mortgagee as to the debtors’ royalty interest as follows:

Oil and gas in place are part of the realty until they are actually severed from the soil [citing *Peppers*, 256 P.2d at 446]. When Debtors mortgaged their property to Bank without reserving or excepting the mineral rights, Bank obtained a security interest in the mineral rights. Okla. Stat. Ann. tit. 16, § 17 (West 1986).

....
[Judge TeSelle then concluded that a lease bonus is payment for an option to explore for minerals, not a purchase of minerals, and therefore was not covered by the mortgage].

....
In contrast, a royalty interest “is a part of the mineral interest.” *Barkett*, 256 P.2d at 446 Bank has a security interest in the minerals until such time as they are severed, and its security interest will continue in the oil and gas after extraction.

Id. at 7-8. See also *infra* note 47 (the *Burris* cases); *Oil and Gas Financing*, *supra* note 1, at 68-70 and authorities cited therein. While this seems clear enough as a matter of general principle under current law, it is a source of problems in this area, owing to the fact that minerals clearly become personal property upon removal.

On a related issue, the characterization of a royalty interest as real property led the Oklahoma Supreme Court to conclude that royalty payments are profits issuing from the land, so that a right to receive future royalty payments should be treated as real property. *Id.* at 68 nn.78-79 (citing *McCully v. McCully*, 86 P.2d 786, 788 (1939)). The Supreme Court of Texas recently held that a mineral interest which had been severed from the surface rights was not covered by the assignment of a deed of trust covering the surface, even though the assignor owned both the deed of trust and the mineral rights. See *Smith v. Williams*, 33 Tex. Sup. Ct. J. 280 (1990).

royalty interest; nonetheless, as explained *infra*, they should be treated as general intangibles under article 9.¹⁵ A production payment contract is similar to a royalty interest in the sense that it represents a right to receive a share of the proceeds from the production of oil and gas. However, a production payment contract has no direct connection to minerals in the ground; like a working interest it is essentially a creature of contract relating to the production and sale of personal property and usually arises between parties who have no interest in the land. Furthermore, unlike a royalty interest, the production payment contract typically terminates at a certain dollar amount. While some courts have treated the right to such payments as real property, it seems more logically to be a general intangible as defined at U.C.C. section 9-105.¹⁶

In Oklahoma, a lease bonus payment (a payment to the lessor as part of the consideration for executing the lease) has been held to be personal property, and the right to receive such a payment should be considered a general intangible under U.C.C. section 9-106.¹⁷ Production payment contracts and working interests should be treated likewise, although again Oklahoma law is not clear on this point. As a result of uncertainties regarding these characterizations, it is possible that similar interests may be treated differently within the same state and differently still in other states, depending on whether the interest in question is considered real or personal property (or some other type of personal property) under state law.

Oil and Gas Production

Oil and gas in the ground can be sold pursuant to U.C.C. article 2 even though it is not then considered personal property subject to article 9.¹⁸ However, the interest so acquired will be subject to real estate interests created before extraction.¹⁹ While not directly relevant to an inquiry under article 9, the article 2 distinctions, and the relative paucity of similar guidance under article 9, once again suggest a need to better coordinate the effects of articles 2 and 9 and real property law in this context.²⁰

15. See also 12A OKLA. STAT. § 9-106 (1981); *Oil and Gas Financing*, *supra* note 1, at 69. But see *Davis v. Lewis*, 87 Okla. 54, 100 P.2d 994 (1940) (assignment of production payments is a contract relating to real estate). Cf. *In re Greater Atlantic & Pacific Inv. Group, Inc.* (Victor Savings and Loan Assoc. v. Grimm), 6 U.C.C. Rep. Serv. 2d (Callaghan) 1565 (Bankr. N.D. Okla. 1988) (motel receivables not rent).

16. 12A OKLA. STAT. § 9-106 (1981). It has been reported that operating agreements, production sales contracts, and the like are general intangibles under the Texas U.C.C. See Denny, *Oil and Gas: The Basics of an Oil and Gas Secured Transaction at E-11* (material presented at the 14th Annual Convention of the Texas Association of Bank Counsel, Oct. 11, 1990).

17. As discussed *infra* note 9 and accompanying text, the provisions relating article 9 to real property law leave many questions unanswered.

18. See 12A OKLA. STAT. § 2-107(1) (1981).

19. See *id.* § 2-107(3). Subsection 2-107(3) also provides for recording of the sales contract in order to make it effective under real property law. Cf. 12A OKLA. STAT. § 9-402(5) (Supp. 1985) (perfection of article 9 security interest by filing or recordation in the real estate records).

20. See *supra* notes 9, 18.

Severed oil and gas is personal property, subject to article 9. However, it may remain subject to prior claims asserted under real property law.²¹ Furthermore, under article 9, a sale of oil and gas at the wellhead to a buyer in the ordinary course of business will cut off a prior article 9 security interest created by the seller, and the buyer will take free and clear of any such interest.²² There is no equivalent rule cutting off real estate claims. In these circumstances the article 9 secured party financing the production likely will lose priority to both the buyer of the minerals and a competing real estate mortgagee. Therefore, it is important that the article 9 secured party who financed the production be able to successfully assert a claim to the proceeds of the sale.²³

Non-uniform amendments to the Oklahoma U.C.C. add another twist to these issues by providing special rules for perfection as to oil and gas proceeds and related personal property collateral by means of recording a real estate mortgage. In addition, these issues may be affected by special state statutory liens designed to protect mineral interest owners.²⁴

Accounts and Proceeds — Article 9 Problems

As noted above, a sale of oil or gas at the wellhead often will cut off an article 9 security interest created by the seller.²⁵ However, such a sale

21. See *supra* notes 6, 9-14.

22. See 12A OKLA. STAT. §§ 1-201(9) (1981); 12A OKLA. STAT. § 9-307(1) (Supp. 1988).

23. There is a high risk that the article 9 security interest in the minerals will be cut off under 12A OKLA. STAT. § 9-307(1) (1981), or will be subordinate to a prior realty claim. See *Oil and Gas Financing*, *supra* note 1, at 70-71; discussion *infra* text accompanying notes 36, 81, 92, 97, and 112. In most cases the nonuniform amendment at 12A OKLA. STAT. § 9-402(5) (Supp. 1985) should provide article 9 protection for the claim to proceeds, as discussed *infra* notes 95-99 and accompanying text. Another option under article 9 is to take a direct security interest in the seller's accounts. However, it should be noted that in either case a security interest in accounts arising from the sale of oil and gas will be subject to special rules, pursuant to 12A OKLA. STAT. §§ 9-103.1(5), 9-402(5) (Supp. 1985), and possibly other law, as discussed *infra*. Of course one solution to these problems is to obtain a mortgage lien entitled to priority under real property law, and this is in fact the solution of choice in many cases. But whether this should be the primary solution, from a public policy standpoint, is an entirely different question, as discussed throughout this article. See, e.g., *infra* notes 81-82 and accompanying text.

24. Non-uniform Oklahoma U.C.C. provisions call for perfection of a security interest in personal property relating to a producing oil or gas well by recording a real estate mortgage or filing a specially designated financing statement in the county where the well is located. See, e.g., 12A OKLA. STAT. §§ 9-401(1)(b), 9-402(5) (Supp. 1985), discussed in *Oil and Gas Financing*, *supra* note 1, at 71-74, and *infra* notes 32-35, 42-45 and accompanying text. Texas has similar but slightly less comprehensive provisions. TEX. BUS. & COM. CODE ANN. § 9.402(a), (e), (f) (Vernon Supp. 1991). The effects of these nonuniform amendments and their impact on a claim to proceeds is discussed more extensively *infra* notes 25-38. See also discussion *infra* notes 48-99 and accompanying text on statutory mineral interest owners' liens.

25. See 12A OKLA. STAT. §§ 1-201(9), 9-307(1) (1981). Special language at § 1-201(9) applicable to buyers of oil and gas at the wellhead reinforces this result. However, as noted *supra* notes 6-14, this article 9 provision will not bar a claim to the minerals asserted under real property law.

will normally generate proceeds²⁶ in the form of an account,²⁷ cash proceeds,²⁸ or some other form of personal property (e.g., chattel paper or perhaps even goods in a barter transaction).²⁹ If the security interest is properly perfected pursuant to the non-uniform provision at Oklahoma U.C.C. subsection 9-402(5),³⁰ the secured party should be able to claim a perfected security interest in accounts or other personal property proceeds generated by the sale of any minerals produced.³¹

Oklahoma and Texas have enacted somewhat similar nonuniform U.C.C. amendments, calling for perfection of a security interest in certain oil- and gas-related collateral (including accounts and proceeds) by recordation of a real estate mortgage or by filing a special financing statement in the real estate records of the county where the well is located.³² Under the Oklahoma provision, a security interest in oil and gas production and certain related personal property can be perfected only by recording a real estate mortgage, or filing a financing statement designating that it is to be indexed in the real estate records. Such a security interest cannot be perfected by the ordinary filing of a financing statement.³³

Oklahoma U.C.C. subsection 9-402(5) provides that a financing statement covering oil and gas or related accounts that is recorded and indexed in accordance with that section, or a recorded real estate mortgage covering the land and related minerals, equipment, accounts and proceeds, "shall be effective as a financing statement"³⁴ This should satisfy the test for a claim to proceeds under subsection 9-306(3)(a) requiring that "a filed financing statement covers the original collateral." In addition, in Oklahoma

26. See 12A OKLA. STAT. § 9-306 (1981 & Supp. 1988).

27. See 12A OKLA. STAT. § 9-106 (1981) (definition of "account").

28. "Cash proceeds" are defined broadly to include money, checks, deposit accounts "and the like." 12A OKLA. STAT. § 9-306(1) (Supp. 1985).

29. 12A OKLA. STAT. § 9-306(1) (Supp. 1984). Chattel paper and instruments are defined at *id.* § 9-105(1)(b), (i). For purposes of § 9-306 and the claim to proceeds, instruments are not considered "cash proceeds." See *id.* § 9-306(1).

30. 12A OKLA. STAT. § 9-402(5) (Supp. 1985).

31. See 12A OKLA. STAT. § 9-306(3)(a), (b) (Supp. 1984). If the severed oil and gas was inventory, then any purchase money priority will be limited to cash proceeds. See 12A OKLA. STAT. § 9-312(3) (Supp. 1988); *infra* note 96.

32. See *supra* note 20; *infra* note 33; TEX. BUS. & COM. CODE ANN. § 9.402(f) (Vernon Supp. 1991). As noted *supra* note 28, the Oklahoma nonuniform amendment is broader in scope than the Texas provision and provides for perfection as to a wide range of personal property associated with a producing oil or gas well, by means of describing the collateral in a real estate mortgage recorded in the county where the well is located. The nonuniform Oklahoma provision also permits perfection as to certain oil and gas related collateral by filing a financing statement that indicates it is to be indexed in the real estate records. See 12A OKLA. STAT. § 9-402(5) (Supp. 1985); *supra* note 24; *infra* notes 33-35, 42-45 and accompanying text.

33. See *supra* notes 20, 24, 32. Perfection can be achieved by using an ordinary financing statement, but it must be recorded in the real estate records and must state that it is to be indexed accordingly. See 12A OKLA. STAT. § 9-402(5) (Supp. 1985). In Oklahoma the financing statement does not have to be acknowledged. *Id.* This may not be the case in other states. See, e.g., *Gulf Prod. Co. v. Continental Oil Co.*, 139 Tex. 183, 164 S.W.2d 488 (1942).

34. 12A OKLA. STAT. § 9-402(5) (Supp. 1985).

the general rules governing the place to file call for perfection in the real estate records of the county where the collateral is located.³⁵ As a result, the oil and gas lender who has followed this type of nonuniform state law on perfection should have a perfected claim to accounts and other proceeds produced by a sale of oil and gas at the wellhead, under U.C.C. sections 9-306 and 9-402(5).³⁶

However, these nonuniform amendments leave a number of questions unanswered. For example, in Oklahoma it is not clear how to determine priority in a conflict between a real estate mortgage and a security interest perfected by a recording in the real estate records under U.C.C. sections 9-401 and 9-402(5). Perhaps the first-in-time and other priority rules of U.C.C. section 9-312 would still apply, but this is not clear.³⁷ Other uncertainties regarding the scope and effect of article 9, as opposed to real estate law in these circumstances, further cloud the legal issues in oil and gas financing and represent a number of potential U.C.C.-real property law conflicts.³⁸ The simple fact is that the relative scope of the two competing bodies of law in this context is not known, and as a result many important questions cannot be answered.

Oil and Gas Equipment

Equipment used for exploring, drilling, producing, storing, or transporting minerals, or servicing oil and gas operations generally will be classified as "goods" under article 9³⁹ and will fall into the article 9 subcategory of "equipment."⁴⁰ Subject to certain exceptions, perfection for ordinary equipment is usually accomplished by statewide central filing in the U.C.C. records.⁴¹

However, as noted, Oklahoma and Texas have enacted nonuniform amendments that call for perfection of a security interest in a wide range of personal property relating to oil and gas production by recordation of a real estate mortgage or specially designated financing statement in the real estate records of the county where the well is located.⁴² In Oklahoma it is

35. 12A OKLA. STAT. § 9-401(1)(b) (Supp. 1987).

36. For additional discussion of proceeds, see *infra* notes 93-98 and accompanying text.

37. Another candidate is the real estate first-in-time rule at 42 OKLA. STAT. § 15 (1981) ("Other things being equal, different liens upon the same property have priority according to the time of their creation. . . ."). Differences between these rules make the distinction important.

38. For example there are differences relating to future advances, purchase money priority, and after-acquired property. See *infra* text accompanying notes 95-105. Cf. 12A OKLA. STAT. § 9-301 (Supp. 1985); 12A OKLA. STAT. § 9-312 (Supp. 1988); 42 OKLA. STAT. § 15 (1981).

39. See 12A OKLA. STAT. § 9-105(h) (Supp. 1984).

40. 12A OKLA. STAT. § 9-109(2) (1981).

41. See 12A OKLA. STAT. § 9-302 (Supp. 1985); 12A OKLA. STAT. § 9-401(1) (Supp. 1987). There are exceptions for vehicles, real estate, and certain specialized types of equipment, including certain oil and gas equipment. See 12A OKLA. STAT. §§ 9-104(a), 9-104(i) (Supp. 1989); 12A OKLA. STAT. §§ 9-302(3), 9-402(5) (Supp. 1985).

42. See 12A OKLA. STAT. § 9-402(5) (Supp. 1985). See also *supra* notes 20, 26. Presumably this would only apply to equipment owned by the debtor who is drilling the well, and would

not clear whether this is limited to equipment that is being used while the well is producing or whether it applies equally to equipment normally used for that purpose but not currently in use (the statute applies to "equipment used in mining, storing, treating and marketing such minerals"). As a result, the exact scope of this provision is not clear.

Uncertainties regarding the production status of the well or actual or normal use of the collateral may suggest a need to file and search both centrally and locally in some circumstances, in order to protect the interested party under both the special rules at subsection 9-402(5) and any other potentially applicable law. For example, a secured party also can perfect a security interest in goods by taking possession of the collateral, although that may not be practical in the context of oil and gas collateral.⁴³ Additionally, there is the possibility that some mobile equipment could be characterized as a vehicle or "mobile goods" subject to other special perfection and choice of law rules.⁴⁴ Finally, various pre-code lien laws have survived the U.C.C., and others have been more recently enacted. These may require an additional filing or recording as protection against certain third party interests.⁴⁵

As a result of this matrix of uncertainties, a party searching for competing security interests with regard to oil and gas equipment located in Oklahoma may have to search as many as eight different sources of perfection or possible characterizations of the collateral, *e.g.*, (1) the real estate records in the county where the well is located, pursuant to Oklahoma U.C.C. subsection 9-402(5); (2) the central filing records pursuant to the perfection rules for ordinary goods at U.C.C. section 9-401; (3) the perfection rules in the state where the debtor is located (for intangibles, mobile goods, certain accounts under U.C.C. section 9-103(3), and certain nonuniform state amendments — despite subsection 9-103(5)); (4) possession of the collateral (in the event of perfection by possession); (5) non-U.C.C. state

not cover equipment leased by the debtor from third parties or not otherwise involved in drilling or operating the well. However, the statutory language is not entirely clear on this point.

It seems logical that § 9-402(5) is intended to cover only wellhead equipment, that is, equipment located on and affixed to the well bore. However, the statutory language is not specific on this point.

Section 9-402(5) also permits perfection by filing a financing statement in the local records, indexed to the real estate records, but it is not clear from the statutory language that the scope of this rule extends to equipment. *See id.*

43. 12A OKLA. STAT. § 9-305 (Supp. 1984). *See also id.* § 9-203(1)(a) (attachment by possession).

44. *See* 12A OKLA. STAT. §§ 9-103(2)-(3), 9-302(3)(b) (Supp. 1985); 47 OKLA. STAT. § 1-101 (1981); *In re Sooner Oil and Gas Corp.*, 24 Bankr. 479 (Bankr. W.D. Okla. 1982); *Oil and Gas Financing*, *supra* note 1, 79-85.

45. *See, e.g.*, 60 OKLA. STAT. § 319 (1981), *discussed in Oil and Gas Financing*, *supra* note 1, at 75-76. *See also* 42 OKLA. STAT. § 144 (1981) (statutory lien for labor or services rendered with regard to an oil or gas well); Harrell & Dancy, *Creditor Lien Rights in Oklahoma and the Impact of Bankruptcy*, 10 OKLA. CITY. U.L. REV. 455 (1985) [hereinafter *Creditor Lien Rights*]; discussion of statutory mineral interest owner's liens *infra* notes 48-99 and accompanying text.

lien laws; (6) the certificate of title lien entry system as to vehicles; (7) possible perfection against the collateral as inventory; and (8) the perfection rules applicable to fixtures.

Conversely, to fully be protected the secured party may need to perfect by means of a combination of more than one of these approaches, in order to guard against an uncertain resolution of the issues noted above. The ability of the trustee in bankruptcy to exercise a lien under state law and avoidance powers⁴⁶ suggests that the failure of a secured party to cover all possible bases could provide grounds for attack by a trustee asserting the rights of a lien creditor without notice of the security interest.⁴⁷ If the secured party has failed to file or otherwise perfect in the correct manner, the result could be loss of priority as against the trustee or other parties. Again, this requires a multiplication of efforts by lenders and other interested parties, and statutory clarification and simplification regarding perfection and priority of security interests in oil- and gas-related equipment would seem to be an appropriate part of any article 9 revision project.

Other Oil and Gas Liens

Both Texas and Oklahoma have enacted special state statutes apparently designed to alter the relative rights of buyers and sellers (as well as other

46. See 11 U.S.C. § 544(a), (b) (Supp. II 1984).

47. *Id.* See also 12A OKLA. STAT. § 9-301 (Supp. 1985). Bankruptcy issues are largely beyond the scope of this paper. There are, however, a number of bankruptcy problems unique to oil and gas collateral. See, e.g., Davis, *Unassigned Oil and Gas Interests in Bankruptcy*, 22 TULSA L.J. 325 (1987).

A series of recent decisions from the Eastern District of Oklahoma illustrates the sometimes stormy relationship between oil and gas law and the Bankruptcy Code. In *In re Burris*, 102 Bankr. 822 (Bankr. E.D. Okla. 1989), the bankruptcy court initially held that perfection of a security interest in oil and gas by recordation of a mortgage pursuant to 12A OKLA. STAT. § 9-402(5) (Supp. 1985) is not "mature" until default and therefore was "inchoate" and not enforceable in bankruptcy. *Burris*, 102 Bankr. at 824. This decision was reconsidered in *In re Burris*, 107 Bankr. 342 (Bankr. E.D. Okla. 1989), and the court issued a "clarification" of its previous position by emphasizing its conclusion that the lender's security agreement was in the form of an absolute assignment that was void as a forfeiture under 42 OKLA. STAT. 42, § 10 (1981) (subsequently amended as 46 OKLA. STAT. § 4 (Supp. 1986) to allow rent assignments as security). The court concluded, however, that even under § 10 the assignment would be valid in bankruptcy if it were "perfected" by compliance with the notice procedure stipulated in 11 U.S.C. § 546(b) (1982 & Supp. II 1984). *Burris*, 107 Bankr. at 344-45. Because the secured party had filed such a notice, it was deemed perfected and treated as having a secured claim in bankruptcy. *Id.* at 346. The court also concluded that the assignment of a security interest in rents and royalties implied an authority for the debtor to execute an oil and gas lease without consent of the secured party (in order to produce proceeds to be encumbered by the mortgage).

In turn, this decision was reconsidered and partially vacated by a "Correction Order" and opinion in *In re Burris*, 109 Bankr. 1018 (Bankr. E.D. Okla. 1990). In that decision, the court conceded that absent subordination by the mortgagee, the oil and gas lease could be defeated by the foreclosure of the mortgage. The court then established a procedure calling for the mortgagee to approve and subordinate its interest to any oil and gas lease, in return for application to the secured indebtedness of any bonuses, rentals, or other proceeds of the royalty interest. *Burris*, 109 Bankr. at 1020. At no point in those opinions does it appear that the court recognized the existence of a security interest under U.C.C. § 9-402(5) (1982) or considered the possible impact of article 9 on these issues.

parties) with regard to oil and gas production. The Oklahoma Oil and Gas Owners' Lien Act,⁴⁸ like nonuniform section 9.319 of the Texas U.C.C.,⁴⁹ apparently was intended to protect the interests of mineral owners against competing claims to proceeds from the sale of minerals. These statutes impose statutory liens (labeled "security interests") on oil and gas production and its proceeds, enforceable with certain exceptions against purchasers of the minerals and other third parties. One significant difference between the Oklahoma and Texas approaches is that the Oklahoma statute requires that the interest owner comply with certain notice requirements.

The Oklahoma Oil and Gas Owners' Lien Act⁵⁰ provides a "security interest in and lien upon" oil and gas production sold (and its proceeds) to secure the mineral interest owner's claim to his or her share of the purchase price.⁵¹ This lien is not effective until the interest owner delivers (by registered or certified mail) a statutory "notice of lien" to the purchaser.⁵² Any purchaser who pays the purchase price to the interest owner or to the interest owner's authorized representative is deemed to be a buyer in the ordinary course of business who takes free and clear of the interest owner's lien.⁵³

48. See the Oklahoma Oil and Gas Owners' Lien Act, 52 OKLA. STAT. §§ 548-558 (Supp. 1988). See also 42 OKLA. STAT. § 144 (1961) (statutory lien for labor or services rendered with regard to an oil or gas well); see generally *Creditor Lien Rights*, *supra* note 45.

49. TEX. BUS. & COM. CODE ANN. § 9.319 (Vernon Supp. 1991) (Texas U.C.C.). In Texas, lenders must also deal with a special mineral contractor's lien, which is similar to the mechanics' and materialmen's liens encountered in real estate transactions. See chapter 56 of the Texas Property Code, TEX. PROP. CODE ANN. §§ 56.001-56.045 (1984), and *In re Meg Petroleum Corp.*, 61 Bankr. 14 (Bankr. N.D. Tex. 1986). For a discussion of similar liens in Oklahoma see *Credit Lien Rights*, *supra* note 45; statutory lien noted *supra* note 48. Unlike the equivalent Oklahoma liens, the Texas mineral contractors' lien does not attach to extracted minerals or their proceeds. See *United States v. Texas E. Transmission Corp.*, 254 F. Supp. 114 (W.D. La. 1965); *Wilkins v. Facht*, 356 S.W.2d 855 (Tex. Civ. App. 1962). These issues are also discussed in *Denny*, *supra* note 16, at E-21.

50. 52 OKLA. STAT. §§ 548-558 (Supp. 1988).

51. *Id.* § 548.2(A). Despite use of the term "security interest," this does not appear to be anything more than a statutory lien. This statute may have been inspired partly by the "trust fund" statutes designed to protect sellers of livestock and agricultural commodities. See, e.g., *In re Samuels & Co.*, 510 F.2d 139 (5th Cir. 1975), *rev'd*, 526 F.2d 1238 (5th Cir.), *cert. denied*, 429 U.S. 834 (1976). In response to this case, a 1984 amendment to the Perishable Agricultural Commodities Act, 7 U.S.C. § 499e(c) (1982 & Supp. II 1984), extended the trust fund concept to perishable commodities. See B. CLARK, *supra* note 1, ¶ 8.04[4]. In turn this legislation apparently inspired state trust fund or "escrow" statutes designed to create something in the nature of a statutory lien in favor of other sellers of agricultural commodities. See, e.g., 2 OKLA. STAT. § 752 (Supp. 1988). The enforceability of some of these state laws in bankruptcy may be subject to attack if they are characterized as state statutory liens designed to alter priorities in bankruptcy. See, e.g., 11 U.S.C. § 545 (Supp. II 1984).

52. 52 OKLA. STAT. § 548.2(C) (Supp. 1988). See *id.* § 548.4 for the required form of the notice. One obvious problem for the interest owner is to identify and locate the prospective purchaser in advance of payment. The lengthy process of executing division orders should facilitate this effort.

53. *Id.* § 548.2(D). This suggests a need for the purchaser to have the operator designated as the agent of all mineral owners.

There is a specific provision in the Oklahoma Oil and Gas Owners' Lien Act which appears to have been designed to protect a perfected article 9 security interest from subordination to an interest owner's lien under this statute. Subsection 548.6(C) provides: "Nothing in this Act shall be construed to impair or affect the rights and remedies of any person under the provisions of the Uniform Commercial Code"⁵⁴ While this provision seems clear on its face and apparently was intended to provide for the continued priority of a perfected article 9 security interest,⁵⁵ it has been argued that this language was intended only to make clear that the statutory lien is not an interest owner's exclusive remedy.⁵⁶ In the latter view, the additional language at subsection 548.4(C) (providing for a relation-back of the statutory lien to the date of severance of the minerals) overrides the "general language" at subsection 548.6(C) and would allow the statutory lien to take priority over a perfected security interest.⁵⁷ While such a meaning is not apparent from the language of the statute, the fact that such an argument has been made illustrates the risks to lenders posed by the potential for creative arguments under these kinds of state law oil and gas lien statutes.

From this standpoint the Texas statute is even worse than the Oklahoma lien act.⁵⁸ Like the Oklahoma Oil and Gas Owners' Lien Act, Texas U.C.C. section 9.319 apparently was enacted in an effort to protect oil and gas interest owners from well operators who produce and sell minerals and then become insolvent or file bankruptcy without distributing the sales proceeds.⁵⁹

54. *Id.* § 548.6(C).

55. This is the clear meaning of the statutory language, and is also consistent with longstanding precedent in Oklahoma. The Oklahoma courts consistently have upheld the priority of a perfected article 9 security interest as against unrecorded ("secret") statutory liens, regardless of which was first in time. *See, e.g., In re N-Ren Corp.*, 773 P.2d 1269, 1271-72 (Okla. 1989) (citing G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY §§ 9.1, 10.1 (1965)); *Republic Bank & Trust Co. v. Bohmar Minerals, Inc.*, 661 P.2d 521, 524 (Okla. 1983); *Leger Mill Co. v. Kleen-Leen, Inc.*, 563 P.2d 132, 188 (Okla. 1977); *Creditor Lien Rights*, *supra* note 45, at 490-515.

56. *See* Plaintiff's Objection to Norwest's Motion for Summary Judgment and Brief in Support Thereof at 3-5, in *Spectrum Gas Sys. v. Norwest Bank*, No. 89-03539-C (Bankr. N.D. Okla. 1989).

57. Subsection 548.4(C) states that it provides priority "over the rights of all persons whose rights or claims . . . arise or attach between the time the [statutory] security interest and lien attaches [i.e. the time of severance] and the time of filing." 52 OKLA. STAT. § 548.4(C) (Supp. 1988). Because the article 9 security interest cannot attach until the minerals have been severed from the real property so as to become goods, the argument is that the article 9 security interest attaches after severance and is therefore subordinate to the lien under the provisions of § 548.4(C).

58. This analysis is indebted to Grinstead, *The Effect of Texas U.C.C. Section 9.319 on Oil and Gas Secured Transactions*, 63 TEX. L. REV. 311 (1984). Grinstead's analysis may have been impacted by a subsequent 1987 revision of § 9.319 which provides that an operator who receives the proceeds of production is deemed to be the first purchaser, thereby creating a § 9.319 lien. *See* TEX. BUS. & COM. CODE ANN. § 9.319(q)(3) (Vernon Supp. 1991). This could affect the priority of a competing article 9 security interest in the operator's inventory of oil and gas and its proceeds because the § 9.319 lien is deemed to be a purchase money security interest and may also be entitled to priority under § 9.319(g).

59. Grinstead, *supra* note 58, at 311, 322-23.

The basic approach of the Texas statute is to give the mineral interest owner a statutory purchase money "security interest" in oil and gas, as security for the purchaser's obligation to pay the purchase price to the interest owner.⁶⁰

To the extent that this effort is successful, however, section 9.319 may also establish priority as against previously perfected security interests in the same collateral, because of the special priority accorded purchase money security interests at U.C.C. subsections 9-312(3) and (4).⁶¹ Furthermore, a purchaser of inventory in the ordinary course of business takes free and clear of any article 9 security interest created by the seller, under U.C.C. subsections 1-201(9) and 9-307(1).⁶² In contrast, Texas U.C.C. section 9.319 purports to create a security interest that is good against such a purchaser.⁶³ While the impact of section 9.319 in these circumstances is not entirely clear, it is possible that the Texas provision could usurp the U.C.C. priority system by subordinating the rights of the buyer (and security interests created by the seller) to the section 9.319 lien as to any minerals sold and their proceeds.

At the same time it is not clear that Texas U.C.C. section 9.319 will always protect the beneficiaries of the lien from the buyer in the intended manner. Section 9.319 is not a statutory lien in the usual sense. Instead it purports to create a perfected U.C.C. purchase money security interest when the mineral interest owner signs a lease (or similar writing) and the purchaser of the minerals recognizes the interest owner's ownership rights and/or his or her claim to the proceeds by signing an agreement, division order, "or . . . any other voluntary communication to the interest owner or any governmental

60. *Id.* Again, parallels to the agricultural trust fund statutes (designed to protect the sellers of agricultural products) are apparent. See *supra* note 51. However, these parallels have limits. One apparent purpose of the trust fund statutes is to protect sellers from a buyer's bankruptcy; this may expose the state "trust fund" statutes to attack in bankruptcy as statutory liens or state law priorities under 11 U.S.C. § 545 (1988). The federal trust fund statutes have no such weakness. Unlike the state trust fund statutes and oil and gas liens, the federal agricultural trust fund statutes do not confront the problem of § 545 and the supremacy clause of the U. S. Constitution in bankruptcy, because the federal trust fund statutes do not involve a conflict between state and federal law. The state oil and gas liens are not directed at the insolvency of the buyer, unlike some of the state agricultural trust fund statutes (making the oil and gas liens less vulnerable under 11 U.S.C. § 545), and the state oil and gas liens seem directed (or at least are most effective) against private secured parties, rather than the trustee in bankruptcy. Additionally, the oil and gas statutes directly provide liens rather than wrapping the seller's protection in the mantle of a "trust fund" or "escrow" account. For these reasons the analogies that can be drawn to the agricultural statutes are of very limited use in analyzing the oil and gas liens, despite the apparent similarities in legislative motivation.

61. TEX. BUS. & COM. CODE ANN. § 9.312(c) (Vernon Supp. 1991). It does not seem entirely clear that the § 9.319 lien will qualify as an article 9 security interest for this purpose, despite the apparent purpose of the statute.

62. 12A OKLA. STAT. §§ 1-201(9), 9-307(1) (Supp. 1990). The impact of these provisions in this context is buttressed by the following language: "All persons who sell minerals or the like (including oil and gas) at wellhead or minehead shall be deemed to be persons in the business of selling goods of that kind." *Id.* § 1-201(9). See also *Oil and Gas Financing*, *supra* note 1, at 70-71. As noted *supra* note 6, this will not preclude assertion of rights under real property law.

63. TEX. BUS. & COM. CODE ANN. § 9.319 (Vernon Supp. 1991)).

agency. . . ."⁶⁴ In a sense, then, Texas U.C.C. section 9.319 seeks to provide an alternative to U.C.C. sections 9-203, 9-302, and 9-401 as a means of attachment and perfection of a security interest in these circumstances. Nonetheless, there remains an obvious question of whether the necessary requirements of article 9 attachment are met under Texas U.C.C. section 9.319, and it seems possible that the rights created could be characterized as essentially nonconsensual and therefore subject to attack in bankruptcy as a statutory lien or state law priority.⁶⁵

Although apparently designed to protect mineral interest owners, the language of Texas U.C.C. section 9.319 protects any "interest owner," suggesting the possibility that it could be used by other parties, perhaps even a lender or other secured party claiming a security interest in the oil and gas production or otherwise taking an assignment of rights from a mineral interest owner.⁶⁶ It is therefore possible that Texas U.C.C. section 9.319 could be used by a creative secured party to usurp the entire article 9 priority system as to conflicts solely between article 9 secured parties. In addition, where the operator is also the first purchaser of the minerals, and qualifies as a buyer in the ordinary course of business, it is possible that the operator could take free and clear of the interest owner's claim under U.C.C. subsection 9-307(1), despite Texas U.C.C. section 9.319 and in derogation of any lien created by the operating agreement.⁶⁷ While these are speculative scenarios, they are illustrative of the kinds of uncertainties created by piecemeal state legislation of this type. As a result, for example, Texas U.C.C. section 9.319 holds at least some potential for gratuitous interference in the U.C.C. priority system without necessarily providing protection to mineral owners in the circumstances where it was intended to operate.

Unlike the Oklahoma Oil and Gas Owners' Lien Act,⁶⁸ Texas U.C.C. section 9.319 provides for automatic perfection of the "security interest" created by the statute, without the necessity of any filing or other notice.⁶⁹ In the case of both the Oklahoma and the Texas statutes, the lien attaches to proceeds of the sale of the minerals. As with other examples of automatic

64. Grinstead, *supra* note 58, at 323-24 (quoting TEX. BUS. & COM. CODE ANN. § 9.319(a) (Vernon Supp. 1991)).

65. See, e.g., Dillon & Harrell, *Anatomy of a Failed Statutory Provision: U.C.C. Section 9-306(4)(d)(ii)*, 43 CONSUMER FIN. L.Q. REP. 198, 213-22 (1989), for a discussion of the general principles governing statutory liens and state law priorities in bankruptcy.

66. See Grinstead, *supra* note 58, at 325. "Interest owner" is defined at § 9.319(q)(2) to include "a person who has an express, implied, or constructive right to receive a monetary payment determined by the value of oil or gas production or by the amount of production." *Id.* This should include the rights of working interest owners, or rights under a production payment contract, and perhaps a nonrecourse security interest.

67. See *id.* at 326. See also *Oil and Gas Financing*, *supra* note 1, at 70-71.

68. See *supra* text accompanying notes 39-49.

69. TEX. BUS. & COM. CODE ANN. § 9.319 (Vernon Supp. 1991). In contrast, the Oklahoma statute makes no real pretense of creating an article 9 security interest and apparently creates only a "lien." However, the lien is not effective until a "notice of lien" is served on the purchaser by certified mail. See *supra* text accompanying notes 42-49.

perfection,⁷⁰ the lack of a filing requirement in Texas U.C.C. section 9.319 is defended by the need to avoid cluttering the U.C.C. filing records.⁷¹ In reality, however, the mineral interest owner in most cases already will have an interest recorded under real property law, and section 9.319(g)(1) also recognizes such a recording as an additional means of perfection. This is philosophically akin to the nonuniform amendment at Oklahoma subsection 9-402(5),⁷² which permits perfection as to a wide variety of oil- and gas-related personal property under article 9 by recordation of a real estate mortgage, except that Texas section 9.319(g)(1) goes beyond perfection issues to determine priority pursuant to real estate law.

Texas U.C.C. section 9.319 specifically cuts off a security interest (including a section 9.319 security interest) against the first purchaser of the minerals upon resale to a subsequent buyer in the ordinary course of business.⁷³ This is similar to the U.C.C. treatment of an ordinary, consensual security interest created by a seller (here the first buyer of the minerals) under subsections 1-201(9) and 9-307(1) of the Uniform Act.⁷⁴ As a result, the holder of a security interest created under Texas U.C.C. section 9.319 (or the Oklahoma Oil and Gas Owners' Lien Act) may be left with only a claim against the proceeds of the resale of the extracted minerals.

There may be some question whether a section 9.319 lien qualifies as a security interest for purposes of perfection and priority as to proceeds under U.C.C. subsection 9-306(3). With regard to the equivalent Oklahoma "lien" (provided by the Oklahoma Oil and Gas Owners' Lien Act) there is no serious

70. See, e.g., 12A OKLA. STAT. § 9-302 (Supp. 1990).

71. See Grinstead, *supra* note 58, at 326.

72. See *supra* text accompanying note 33. There is a similar but more limited provision in Texas. See TEX. BUS. & COM. CODE ANN. § 9-402(f) (Vernon Supp. 1991). The apparent theory behind these nonuniform perfection provisions is that there is no need to cross-index such a recording in the U.C.C. records if there is already a well-recognized recording system for such interests under real property law. See Ryan letter, *supra* note 2, at 2. Ryan is the principal author of the nonuniform amendment at 12A OKLA. STAT. § 9-402(5) (Supp. 1990). Whether or not this kind of bifurcated filing and perfection system (straddling real and personal property law) should be recognized in the Uniform Act is a fundamental matter for consideration as a part of any article 9 review process. While this may be one of the more defensible examples of deference to real property law for article 9 security interests, it obviously imposes a double requirement for title searchers with regard to oil and gas, because extracted minerals could be subject to perfection under either system. In addition, it creates other uncertainties regarding the exact scope of the competing (real and personal property) systems, regarding a variety of issues such as future advances and purchase money priority.

73. See TEX. BUS. & COM. CODE ANN. § 9.319(e) (Vernon Supp. 1991).

74. Because it is not clear that a Texas U.C.C. § 9.319 "security interest" is created by the seller (as opposed to being created by statute) in these circumstances, the related impact of U.C.C. § 9-307(1) is not clear. In any event, if the § 9.319 lien is deemed to be created by the seller (see § 9.319(a)) then it would not be cut off in that transaction under § 9-307(1). When the first buyer subsequently resells the minerals in the ordinary course of business, however, § 9-307(1) might come into play, as noted in *supra* text accompanying note 73. The impact of the Oklahoma Oil and Gas Owners' Lien Act in these circumstances is also not clear, although its specific deference to U.C.C. rights seems to suggest a recognition of § 9-307. Again, however, it is not clear that the Oklahoma lien was "created by the seller" within the meaning of U.C.C. § 9-307(1).

pretense that the lienholder has the rights of a secured party under article 9, and therefore subsection 9-306(3) should not be applicable with regard to the priority of such a lien as to proceeds. However, the Oklahoma lien statute specifically grants the interest owner a lien on the proceeds of the resale in the hands of the first purchaser. The perfection and priority of this lien as against third parties is not clear, because the Oklahoma Oil and Gas Owners' Lien Act has no provision directly equivalent to U.C.C. subsection 9-306(3).⁷⁵

In Texas, section 9.319 purports to create an article 9 "security interest," thereby potentially triggering application of the priority rules governing proceeds at U.C.C. subsection 9-306(3).⁷⁶ In addition, Texas subsection 9.319(c) calls for continued perfection of the section 9.319 security interest "for an unlimited time" as to enumerated proceeds, perhaps thereby overriding the limitations of U.C.C. subsection 9-306(3) regarding a claim to proceeds.⁷⁷ It is even possible, though surely not inevitable, that the Texas lien will be viewed as permanently perfected under section 9.319(c) for purposes of a claim to proceeds, although this seems uncertain and perhaps even a bit far-fetched.⁷⁸ Obviously such a rule would complicate U.C.C. title searching and priority problems even more, perhaps to the extent of frustrating the purposes of the U.C.C. as to a wide range of article 9 collateral potentially affected by a section 9.319 "security interest."

To the extent that article 9 is applicable, the better approach would be to require a party seeking special protection under these oil and gas lien statutes to simply comply with article 9. If additional protection is needed for mineral owners, the preferred solution would be to propose amendment of article 9 to specify and facilitate its application to oil and gas transactions, instead of cluttering state law with these kinds of nonuniform lien statutes.

*Basic Priority Problems — Minerals at the Wellhead Sold as Inventory*⁷⁹

If a sale of minerals at the wellhead is treated as a sale of inventory to a buyer in the ordinary course of business, under U.C.C. subsections 1-201(9) and 9-307(1), the buyer will take free and clear of any article 9 security interest created by the seller.⁸⁰ While the impact on this scenario of Texas U.C.C. section 9.319 or the Oklahoma Oil and Gas Owners' Lien Act may

75. See 52 OKLA. STAT. §§ 548.2(A), 548.6(A); 548.4(B), 548.4(C), 548.5 (Supp. 1990).

76. TEX. BUS. & COM. CODE ANN. § 9.306(c) (Vernon Supp. 1984).

77. See Grinstead, *supra* note 58, at 329.

78. *Id.*

79. This discussion is indebted in part to the Ryan letter, *supra* note 2, and Grinstead, *supra* note 58.

80. As noted *supra* note 22, this argument is bolstered by the language of 12A OKLA. STAT. § 1-201(9) (Supp. 1990). As noted *supra* note 6, this will not affect any claim to the minerals under a real estate mortgage or otherwise successfully claimed pursuant to real estate law. However, as noted *infra* this text, and discussed *supra* at notes 10-11, it appears that an oil and gas lesser/operator never owns an interest in the minerals produced as real property. Therefore, it is not clear that such a party's interest can be encumbered under real property law, outside the U.C.C. See, e.g., *Continental Supply Co. v. Marshall*, 152 F.2d 300 (10th Cir. 1946).

not be entirely clear, it does seem that in this kind of transaction U.C.C. subsections 1-201(9) and 9-307(1) will cut off any security interest created by the seller under article 9. This serves as a reminder that perfection under article 9 may not be sufficient to permit a secured party to claim a security interest in oil and gas production after it has been sold; in consequence, lenders may legitimately feel that they should rely on real property law as to filing and priority for purposes of these transactions.⁸¹ However, since it is not clear that oil and gas was ever owned by the lessee/producer as real property, it is also unclear whether such a party's interest can be encumbered outside article 9.

Moreover, from a policy standpoint it is not clear that real property law should be the primary or even an alternative way to protect a secured party in transactions where minerals are to be severed from the realty and sold as personalty. As proposed in the conclusion to this article, a better approach might be to provide in article 9 for consistent treatment of the sale of oil and gas production as a sale of personal property inventory under article 9, recognizing the primacy of a buyer in the ordinary course of business under subsection 9-307(1) and providing the secured party with an article 9 claim against accounts and other proceeds generated by the sale, free of doubts concerning competing rights asserted under other law. Eliminating the conflicts between real property law and these important article 9 rights would eliminate the need for interested parties to go beyond the article 9 filing requirements in these circumstances and would provide greater certainty and simplicity for both purchasers and secured parties.⁸² It would also lead to greater uniformity between the laws of different states, currently a source of much confusion and many variations.

Possible Impact of Texas U.C.C. Section 9.319 on a Claim to Proceeds

In Texas, the section 9.319 "security interest" is characterized as a purchase money security interest.⁸³ In her article, Cynthia Grinstead ex-

81. See Ryan letter, *supra* note 2. For example, under title 12A, § 9-402(5) of the Oklahoma Statutes, a real estate mortgage covering oil and gas under a rents and profits clause in the mortgage may preserve a claim to mineral production sold as well as proceeds and accounts from the sale (the latter being reinforced by § 9-402(5)). OKLA. STAT. § 9-402(5) (Supp. 1990). See also *supra* note 23.

82. The nonuniform amendment at title 12A, § 9-402(5) of the Oklahoma Statutes, which permits a real estate mortgage to serve as a means of article 9 perfection in these circumstances, represents an alternative approach that incorporates elements of real property law but fails to resolve the conflicts created by this interface between the two systems of law. It should be emphasized that perfection by means of recording a real estate mortgage pursuant to these nonuniform amendments does not negate the effects of § 9-307(1); presumably a buyer in the ordinary course of business will still take free and clear of the article 9 security interest perfected under § 9-402(5) despite this novel method of perfection. See 12A OKLA. STAT. § 9-402(5) (Supp. 1990); *id.* § 9-307(1).

83. See TEX. BUS. & COM. CODE ANN. § 9.319(f)(1) (Vernon Supp. 1991); Grinstead, *supra* note 58, at 331.

plained the interaction of the U.C.C. and Texas section 9.319, where minerals are produced and sold, using a series of examples.⁸⁴ For example, in a conflict between a royalty owner and a secured party claiming only an article 9 perfected security interest in the operator's inventory of oil and gas or its proceeds, the secured party's interest in the oil and gas produced would be cut off by a sale of the minerals in the ordinary course of business, under U.C.C. subsection 9-307(1), but would continue in proceeds of the sale. At the same time, the royalty owner's section 9.319 security interest would be subject to the priority rules at Texas subsection 9.319(g).⁸⁵ Theoretically, this could permit the mineral interest owner to assert the sole claim to the extracted minerals in the hands of the first buyer as a secured party holding a security interest "created" by that buyer under section 9.319.⁸⁶ If, in turn, that purchaser resold the minerals to a second buyer, the mineral interest owner, because of the section 9.319 lien, could likewise be deemed to have the only security interest in the proceeds of that sale in the hands of the first purchaser. These proceeds would be proceeds of the section 9.319 security interest because the claim of the other article 9 secured party to these minerals would have been cut off under U.C.C. subsection 9-307(1) by the first sale. Alternatively, if the operator is considered the first purchaser under Texas subsection 9.319(g)(3), then he or she would have created both security interests and priority could be governed by some other rule, as discussed below.

In still another possible variation, if Texas section 9.319 is interpreted broadly to permit assertion of a security interest or similar claim as an assignee of the section 9.319(q)(2) "interest owner" (for example if the secured party has taken an assignment of rights enforceable under section 9.319), then both a mineral interest owner and the competing secured party would be able to claim the protection of section 9.319, and priority between them would be governed by the rules at section 9.319(g). Once again this would mean that a party who has perfected via a real estate recording would prevail over one who has relied on automatic perfection under section 9.319. If both competing interests have recorded, it is unclear whether they would be deemed to share pro-rata or whether they would be subject to the

84. Grinstead, *supra* note 58. Section 9.319 was revised in 1987 to include an operator who has disbursed the proceeds of production within the definition of first purchaser. See TEX. BUS. & COM. CODE ANN. § 9.319(q)(3) (Vernon Supp. 1991). This could affect the Grinstead analysis when a lender is seeking to enforce a security interest against an operator's inventory or proceeds and is met by the claim of an unpaid mineral interest owner asserting a claim under § 9.319. See also *supra* note 58.

85. This could well lead to priority for the § 9.319 lien, under the priority rules of real property law (incorporated at TEX. BUS. & COM. CODE ANN. § 9.319 (Vernon Supp. 1991)), because the § 9.319 lien will often be the first to have been recorded under real property law. See *supra* notes 58, 84. See also *infra* text accompanying note 85.

86. This "creation" by the buyer is largely a legal fiction, a creature of the statute. See *supra* text accompanying notes 58-61. Again this analysis could be affected by the 1987 revision to § 9.319, characterizing the operator as the first purchaser in some cases. See TEX. BUS. & COM. CODE ANN. § 9.319(q)(3) (Vernon Supp. 1991).

priority rules of article 9 or real estate law.⁸⁷ Both claimants would be able to assert a claim against the first buyer of the minerals and/or the proceeds of the resale subject only to the uncertain applicability of U.C.C. subsection 9-307(1) in the context of this transaction.

In these circumstances, a secured party of the buyer, who had financed the initial purchase of the minerals by that buyer and was claiming a purchase money security interest in the minerals purchased, arguably could be subordinate to the claim of the mineral interest owner (or even a creditor of the operator) asserting the Texas section 9.319 rights described above.⁸⁸ In this context the statutory characterization of the section 9.319 lien as a purchase money security interest⁸⁹ is crucial, because this status could negate the special priority that otherwise could be claimed by a competing purchase money secured party financing the buyer under U.C.C. subsections 9-312(3) or 9-312(4). Without section 9.319, any security interest claimed by a creditor of the seller would be "created by the seller" and hence would be cut off as against the buyer and its secured creditors by U.C.C. subsection 9-307(1). Under section 9.319, however, the security interest is deemed to be created by the *purchaser* of the minerals and therefore survives the sale. As a result the rights of any "interest owner"⁹⁰ or, presumably, an assignee of such an interest owner, would survive the sale and could be asserted against the first buyer and its secured creditors. In this scenario, even if the secured party financing the buyer's purchase obtains a purchase money security interest, it will not be entitled to priority because the section 9.319 interest is also denoted a "purchase money security interest" created by the first buyer.⁹¹ Presumably, then, such a priority conflict would be resolved under the "first-to-file-or-perfect" rule at U.C.C. subsection 9-312(5) (subsection 9.312(e) in Texas); if so, the section 9.319 interest likely would prevail because it could be traced to a real estate recording that probably preceded the purchase transaction (and therefore the perfection of the competing security interest). In effect, Texas U.C.C. section 9.319 has the potential to alter the U.C.C. priority system in this kind of transaction.

The Impact of Real Property Law

Even excluding consideration of Texas U.C.C. section 9.319, there are difficult priority issues that may arise because of the uncertain relationship between article 9 and real property law in these circumstances.⁹² For example,

87. See TEX. BUS. & COM. CODE ANN. § 9.319(g)(1) (Vernon Supp. 1991); Grinstead, *supra* note 58, at 332. Compare 12A OKLA. STAT. §§ 9-301, 9-312 (Supp. 1990) with 42 OKLA. STAT. § 15 (Supp. 1990).

88. *Id.* The results would be even worse if a bankruptcy trustee somehow could finesse his or her way into the posture of a § 9-319 lien holder. See 11 U.S.C. § 544(a) (1988).

89. TEX. BUS. & COM. CODE ANN. § 9.319(f)(1) (Vernon Supp. 1984).

90. "Interest owner" is broadly defined at *id.* § 9.319(q)(2).

91. *Id.* § 9.319(f)(1).

92. This portion of the discussion is indebted to the Ryan letter, *supra* note 2. See also B. CLARK, *supra* note 1, at ¶ 13.02[5] (chapter titled *The Point at Which Article 9 Kicks In*); discussion *supra* note 6; text accompanying *supra* notes 21, 58, 73.

in Texas it has been held that a third party is on notice of the lien created by an operator's agreement because the operator has possession of the leases.⁹³ The same court also held that this unrecorded lien had priority over a perfected security interest because the operator had perfected its lien by possession of the oil produced.⁹⁴ Other issues remain largely unanswered. For example, who has priority in a conflict between the holder of a recorded real estate mortgage and an article 9 security interest which is properly perfected in the same county under the Oklahoma version of article 9, as to oil and gas that has been extracted but not sold? Should this conflict be governed by the U.C.C. priority rules (including the rules regarding purchase money priority), or by the equivalent principles of real estate law? The Oklahoma nonuniform provision at subsection 9-402(5) deals with perfection but not priority issues. There is simply no easy answer to these questions. Nowhere is this gap in the law more apparent than with regard to the proceeds of oil and gas sold at the wellhead.

Priorities in Proceeds⁹⁵

If oil and gas production is deemed to be inventory in the hands of the seller at the wellhead, then article 9 purchase money priority in those minerals will extend only to the *cash* proceeds of any sale.⁹⁶ Accounts or other noncash proceeds received by the seller will not be subject to purchase money priority in these circumstances under article 9. In that event, perfection is not lost; under article 9 the priority of the perfected security interest in noncash proceeds will be governed by the first-in-time rules at section 9-301 or 9-312, as against lien creditors or competing article 9 security interests.⁹⁷ However, the security interest will not have the special priority that is otherwise accorded purchase money loans under those sections. In addition, it is possible that a party claiming accounts or other proceeds under a competing theory or law (e.g., a realty interest claiming under a "rents and profits" clause in a mortgage, or perhaps a claim asserted under a state mineral interest owners' lien act like Texas U.C.C. section 9.319 or the Oklahoma Oil and Gas Owners' Lien Act) could prevail over an article 9 secured party as to the proceeds on the basis of that competing theory or law, regardless of the intended result under article 9.⁹⁸ Under current

93. *MBank Abilene, N.A. v. Westwood Energy, Inc.*, 723 S.W.2d 246, 250 (Tex. App. 1986), discussed in Denny, *supra* note 16, at E-23.

94. *MBank Abilene*, 723 S.W.2d at 253-54, discussed in Denny, *supra* note 16, at E-23 to E-24.

95. This portion of the discussion is indebted to Grinstead, *supra* note 58, at 334-35.

96. 12A OKLA. STAT. § 9-312(3), § 9-301(2) (Supp. 1990). *Cf. id.* § 9-313(4)(a). *But see id.* § 9-402(5) (special rules governing perfection as to proceeds of oil and gas); *id.* § 9-306 (rules on continued perfection as to proceeds). Recall also the broad definition of cash proceeds at *id.* § 9-306(1), which includes several types of liquid assets. *See supra* note 8.

97. 12A OKLA. STAT. §§ 9-301(1)(a), 9-312(4) (Supp. 1990). As noted *supra* notes 6-14 and accompanying text, as against a real property interest the result and even the applicable law is not so clear. *See, e.g.*, 42 OKLA. STAT. § 15 (Supp. 1990).

98. *See, e.g.*, 12A OKLA. STAT. § 9-104(i) (Supp. 1990), exempting from article 9 a real estate interest. The precise impact of this provision in this context is not clear.

law, the priority of a security interest in these circumstances will be subject to the vicissitudes of an unpredictable judicial analysis. The uncertainties inherent in such a conflict again suggest the need for further clarification of the relationship between the U.C.C. and other law in the context of oil and gas security interests.⁹⁹

Fixtures and Equipment

An initial question is whether oil and gas production equipment should be considered a fixture.¹⁰⁰ Oil and gas leases routinely call for the ultimate removal of such equipment. This seems inconsistent with the requisite intent that an installation be permanent, which is typically a part of the definition of "fixture" under state law.¹⁰¹ As a result, the better view is that oil and gas drilling, production, and transportation equipment normally should not be considered fixtures under article 9. Nonetheless, an article 9 revision clarifying this point would help provide a solution to the uncertainties in this area. Perhaps this could be accomplished by a simple addition to section 9-313, dealing with the interface between real and personal property law in the context of oil and gas financing.¹⁰²

Until the uncertainties regarding application of the current section 9-313 to oil and gas collateral are resolved, confusion as to the classification of energy-related collateral and the potential classification of oil and gas equipment as fixtures suggests a need to conduct a fixture analysis in oil and gas financing transactions. As just one example, in *In re K&A Servicing, Inc.*,¹⁰³ the court considered whether a pipeline was a fixture and ultimately concluded that it was ordinary chattel. Some commentators have even suggested that lenders should make a precautionary fixture filing where there is any doubt as to the possible classification of the collateral as a fixture.¹⁰⁴ While undoubtedly this is a prudent step from the standpoint of an individual lender, it results in unnecessary cluttering of the filing records, a problem that could be addressed by an article 9 clarification on this issue.

Additional problems are suggested where there is a conflict between a perfected article 9 security interest covering "all equipment" of the debtor and a real estate mortgage covering real property on which a well is located (with language covering the same oil and gas equipment).¹⁰⁵ Aside from the

99. See *supra* note 6.

100. See *Oil and Gas Financing*, *supra* note 1, at 85.

101. *Id.* See also Ryan letter, *supra* note 2; 12A OKLA. STAT. § 9-313(1)(a) (Supp. 1990) (definition of "fixture").

102. *Id.* See also *supra* note 6; *infra* text under the heading *Summary and Conclusions*.

103. 47 Bankr. 807 (Bankr. N.D. Tex. 1985) (applying Oklahoma law), discussed in *Oil and Gas Financing*, *supra* note 1, at 86-87.

104. See J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE § 23-13, at 943 (2d ed. 1980), cited in *Oil and Gas Financing*, *supra* note 1, at 87 n.190. See also B. CLARK, *supra* note 1, at ¶ 13.04[2].

105. This discussion is indebted to the Ryan letter, *supra* note 2. See also 12A OKLA. STAT. § 9-402(5) (Supp. 1990), which includes a nonuniform amendment extending the reach of the

fixtures issues or questions relating to the appropriate method of perfection under article 9, and regardless of who is first in time, there are basic questions regarding the applicable law: where does real property law end and personal property law begin? In a state like Oklahoma or Texas, the nonuniform amendments which allow article 9 perfection by recordation of a real estate mortgage in these circumstances address some perfection issues (not always clearly) but do not answer other basic questions as to the scope of the applicable law with regard to related issues. When these unresolved issues are mixed with uncertainties regarding the characterization of the property and the method of perfection, the result is often a long list of questions without answers under current law. As just one example, suppose the article 9 security interest was first to be perfected but the borrower then replaces the old equipment by purchasing new equipment with a purchase money loan made pursuant to a future advances clause in the real estate mortgage.¹⁰⁶ What law governs issues such as purchase money priority, future advances, and remedies? Again perhaps the approach and pattern of section 9-313 suggest the basis for a statutory solution.

Choice of Law

Broad choice of law issues are beyond the scope of this article and are covered elsewhere.¹⁰⁷ Suffice it to note here that the distinction (and conflict) between real and personal property law, which is at the heart of so many oil and gas financing issues, also dramatically affects interstate choice of law because virtually all choice of law rules depend upon an initial characterization of the property as either real or personal.¹⁰⁸ In addition, the nonuniformity of state oil and gas laws (including such basic matters as characterization of the collateral) and nonuniform amendments to article 9 create special choice of law problems on top of the layer of perfection and priority issues already discussed in this article.¹⁰⁹

The specific article 9 choice of law rule for oil and gas collateral at subsection 9-103(5) is helpful but does not entirely resolve these problems,

real estate mortgage to virtually all personal property associated with a producing oil and gas well.

106. See the Ryan letter, *supra* note 2. This scenario raises questions concerning priority of a purchase money loan and the effects of a future advances clause under real property law, as compared to the same issues under article 9. While the precise differences need not be explored here, it is apparent that such differences would lead to conflicting results depending on the choice of applicable law.

107. See, e.g., *Oil and Gas Financing*, *supra* note 1, at 87-98; Harrell, *Multistate Concerns: Choice of Law Problems and Related Concerns in the Perfection of Security Interests*, in J. NORTON, T. GILLESPIE, & D. RICE, *COMMERCIAL FINANCE GUIDE* 29-1 to 29-71 (1990) (chapter 29); Harrell, *The Modern World of Conflicts for Article Nine Security Interests, Part I: Multi-State Choice of Law Analysis and the Impact of the 1972 Uniform Revisions*, 42 *CONSUMER FIN. L.Q. REP.* 156 (1988) [hereinafter *Modern World of Conflicts*].

108. *Id.*

109. See, e.g., *Oil and Gas Financing*, *supra* note 1, at 98 n.250.

in part because the application of section 9-103 depends on a prior analysis under section 1-105 of the forum state.¹¹⁰ As a result of section 1-105, there is an inherent bias in favor of the law of the forum, which may classify or treat the collateral differently than does the situs state.¹¹¹ Furthermore, one cannot predict in advance where a lawsuit will be brought, and consequently it is not possible to predict with certainty what the law of the forum will be. In contrast, under the situs-oriented rule at section 9-102 of the 1962 version of the U.C.C., it seemed a safe assumption that the law of the situs would apply under section 9-103. Under the forum-oriented rule of the 1972 amendments, this anchor has been lost. Together with other uncertainties concerning state law classifications of the collateral, the relationship between real and personal property law, and the effect of section 9-103, the result is a surprising amount of uncertainty regarding basic choice of law issues in an area where most practitioners probably assume that a simple "law of the situs" rule still prevails.

Summary and Conclusions

The following six conclusions and recommendations are derived from the foregoing analysis:

1. The special interrelationship between real and personal property law in the context of oil and gas financing transactions is at the heart of the dilemma confronting any effort to provide greater uniformity and consistency in this area of law. This may suggest the need for a special provision, perhaps on the order of section 9-313, to resolve the resultant conflicts and uncertainties. On the other hand, with this approach there is an inherent risk that the disparate treatment of oil- and gas-related collateral under article 9 will be reinforced as a result of the need to accommodate principles of real property law. This disparate treatment within article 9 seems to be one source of our current problems in this area. There is a risk that any solution inspired by section 9-313 would perpetuate or even expand such disparities. This suggests the possible need for an even more radical solution, as noted below.

2. There may be a need for a fundamental shift in the way the law views oil and gas security interests. The basic orientation of the law toward real property concepts probably will have to be overcome if a simple and consistent system is to be constructed. Despite the residue of real property concepts that permeate this area of the law, the law should recognize that extracted oil and gas (and other minerals) are inherently species of personal property, and perhaps the same should be said of the right to explore for and extract minerals in the ground.¹¹²

110. See *Modern World of Conflicts*, *supra* note 107, at 157-58.

111. *Id.*

112. This is implicitly recognized even under real property law, which characterizes a lessee's interest as merely a right to extract minerals and not an estate in real property. See, e.g., *supra* notes 3-13 and accompanying text. Is there any reason not to treat a right to extract minerals as a general intangible under U.C.C. § 9-106, so as to permit perfection as to all

One apparent solution would be to treat oil and gas, and related equipment, accounts, and proceeds, as ordinary personal property subject solely to perfection by possession or central filing under article 9. This would require a major departure from the real estate orientation of current non-uniform provisions such as Oklahoma's subsection 9-402(5). However, the result would be far greater simplicity, consistency, and uniformity in the law nationwide.

3. One of the anomalies of current law is that purely personal property (e.g., severed minerals and related equipment, accounts and other proceeds) may remain subject to the lien of a real estate mortgage long after the end of any direct connection to real property. To resolve the resultant uncertainties, it should be made clear that severance of minerals from the realty cuts off any claim arising under real property law. For example, there should be no claim to severed oil and gas or its proceeds under a "rents and profits" clause in a real estate mortgage. This would reinforce the goals noted at paragraph 2 above, in terms of creating certainty, simplicity, and uniformity in this area of law. It should also be made clear that movable oil and gas equipment is not subject to perfection under real property rules and is not a fixture subject to section 9-313. Perfection as to this type of collateral should be solely by means of the normal U.C.C. perfection system. These changes would eliminate many of the choices between conflicting laws that currently plague analysis in this area of law.

4. Consideration should be given to accommodating within article 9 any legitimate purposes evidenced by the state laws creating statutory liens or security interests in favor of mineral interest owners. Proper integration of such provisions into article 9 would more effectively accomplish the intended purposes, without the unpredictable conflicts that currently exist. The separate and specialized nonuniform statutes should be repealed.

5. These changes could be coordinated with other revisions reflecting the treatment of crops and similar real property-derived inventory collateral as personal property inventory. To the extent possible, there should be consistency and uniformity among the provisions governing crops, timber, minerals, and general personal property inventory. Specialized provisions covering such collateral should have as many common provisions as possible (or perhaps even be contained in a single U.C.C. section that maximizes the common provisions). In turn, these rules should be integrated into the general provisions of article 9, in the same fashion that the section 9-313 rules on fixtures were revised to conform to the basic principles of article 9 as part of the 1972 amendments to the uniform text.

6. The concept of and requirements for filing as to oil and gas collateral in the real estate records, and the provisions calling for perfection as to

such interests owned by a single debtor by means of a single filing in the state where that debtor is located? Cf. 12A OKLA. STAT. § 2-107(1) (Supp. 1990) (sale of minerals in the ground is deemed a sale of goods if they are to be severed by the seller, but until severance there can be no effective transfer under article 2).

such collateral by recordation of a real estate mortgage, should be abandoned in favor of more consistent treatment within article 9.

Overall, the purpose of these changes would be to fully integrate personal property oil and gas financing into the article 9 system, recognizing the inherent personal property characteristics of severed oil and gas, its proceeds, and the equipment used to find, produce, and transport it, thereby reducing the unnecessary complexities, uncertainties, and conflicts with other laws that plague the current system of law governing energy financing transactions. While many oil and gas practitioners and lenders have learned to live with the current system simply by covering all of the bases, it does not follow that this is an optimal solution. The current rules are unnecessarily complex and uncertain, and as a result it is increasingly difficult to anticipate every possible problem in advance. It seems likely that this discourages oil and gas finance and in turn discourages the development of important domestic oil and gas resources.